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DOW THEORY LETTERS INC.

"The Market as Interpreted under the Dow Theory"

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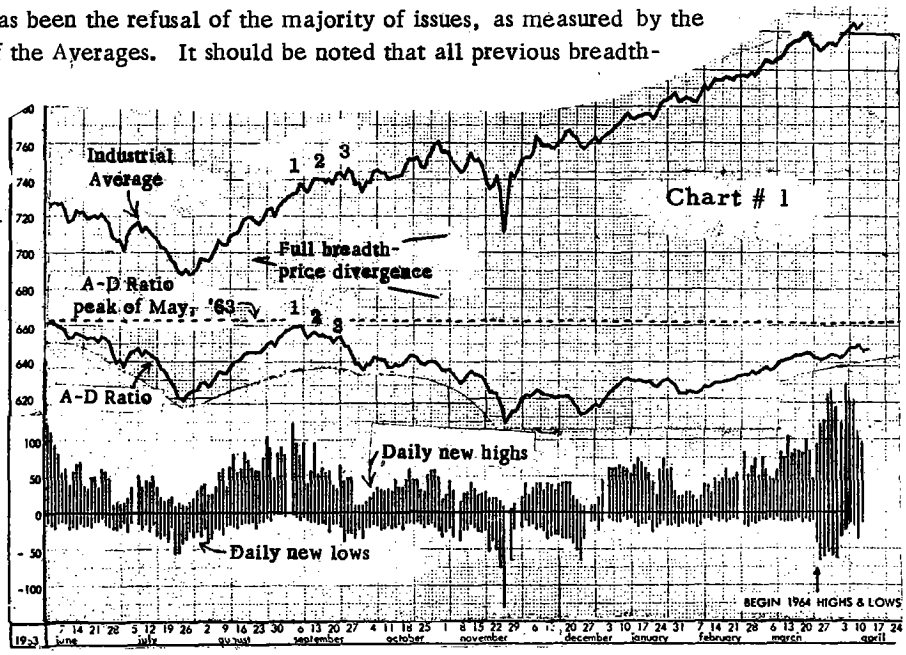
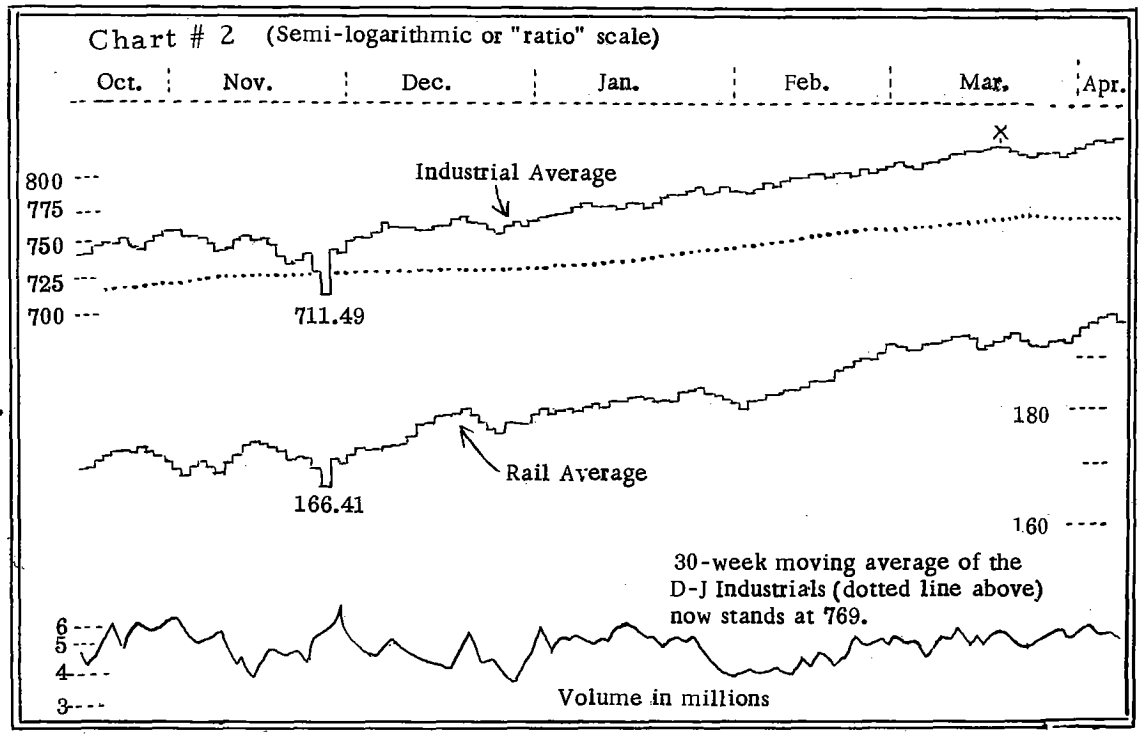
THE MARKET: The market advance which began at the "Kennedy Assassination Lows" has continued with little in the way of interruption. The rise has been fueled by an almost undiluted flood of bullish reports (the Rail strike is the only hint of unpleasantness). Excitement has increased with the further output of good news, and during the 17 days since March 18 (X on chart 1), volume has averaged 5.7 million shares per day. Thus, a good deal of "steam" has been expended to produce a rise of less than 1% in the Industrial Average. While "churning" action is always disconcerting, it does not necessarily mean that trouble is upon us.

A more important "fly in the technical ointment" has been the refusal of the majority of issues, as measured by the advance-decline ratio, to confirm the bullishness of the Averages. It should be noted that all previous breadth-price divergences have given way to important declines. The ability of the Averages to resist decline, following the peak in breadth made 10 months ago (in May, 1963) is already approaching the point where it can be referred to as a "technical marvel". The A-D ratio (see Chart 1) has now pushed fairly close to its May, 1963, high. If this indicator does succeed in climbing to a new peak above the '63 high, it will have accomplished the most astounding (and unprecedented) reversal in the history of the breadth-price relationship.



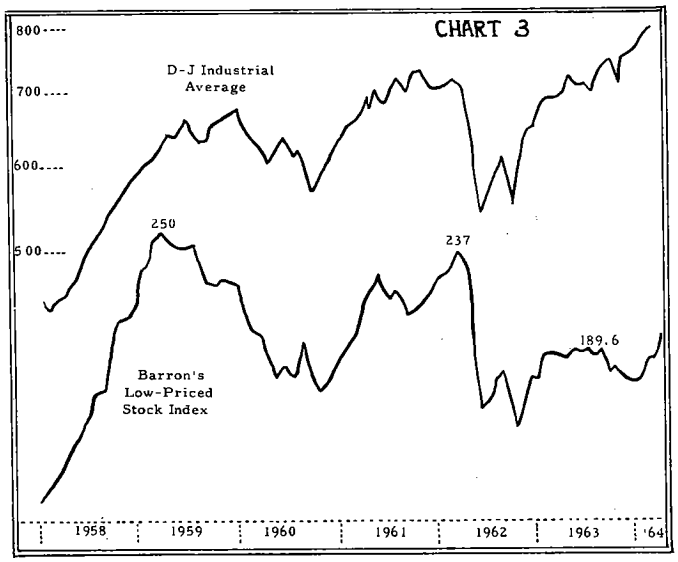
A great many "exchange" investment services are received here each week, and I note that a large majority of the technical services are bullish, while only a very few of the more rounded (fundamental-technical) analysts are bearish. I might also add that the few bearish comments I do read come from veterans and old-timers. For my part, I remember only too well the excitement my first Barron's article (based largely on technical factors) stirred up in 1958. It is somewhat disturbing to see so many commentators basing their bullish predictions on technical factors which they were largely unaware of six years ago.

While the market shows signs of "blowing off" on the upside, it is nevertheless important to remember what we are doing and why (see Stock Section). I still receive correspondence from people who want "stocks for long-term investment purposes" — but one need only glance at Barron's "Market Laboratory" page in order to



question this line of thinking.

The Industrial Average is now on a 3.21% yield and selling at 20 times estimated 1964 earnings. Moreover, the Rails are now on a 3.88% yield, and this represents the first time that the yield on the carrier Average has dropped below 4% since the late 1930's (at which time declining dividends, not rising Rail prices, caused the low yields). As a final aside, it is worth noting that Moody's 125 Stock Index has now dropped under the 3% yield level for the first time since March, 1962. From the standpoint of values, "the investments ain't there."



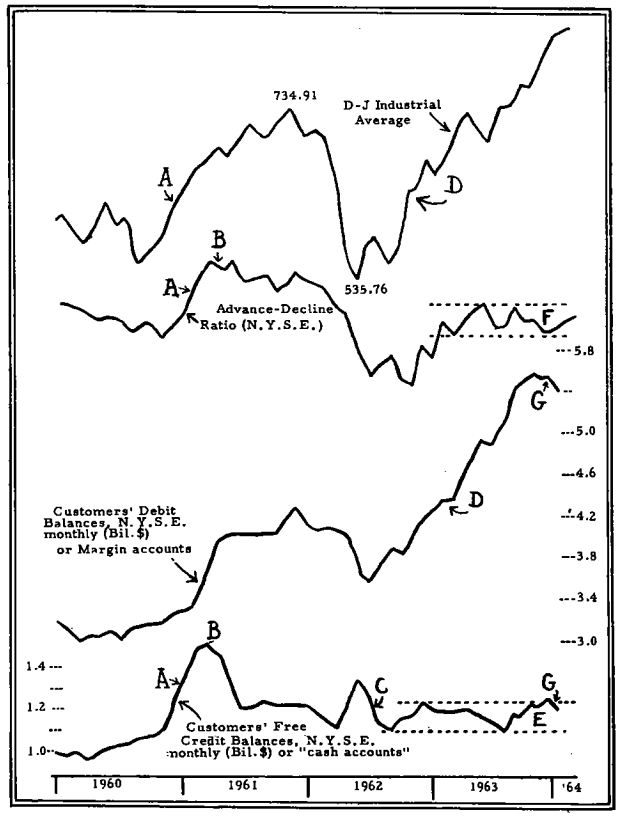
A further extension of the market advance will very probably depend on the willingness of the public to take over from here (see next section on "Significant Changes"). For this reason, it becomes particularly important to watch the gauges of speculative activity. I have included Chart # 3 which shows what might be termed the speculative profile of the market during the past seven years.

Referring to Chart 3, it is clear that Barron's Low-Priced Stock Index has been subject to three important advances since 1958, and this would all seem to be part of an unprecedentedly long (three-part) "third phase" — or giant speculative "wind-up" for the bull market which began in 1949 (see Letter 247). Last week, Barron's Index pushed above its 1963 high of 189.6. For this reason, I would guess that this Index is on its final rise in a formation similar to the 1961-62 pattern (see chart). At any rate, activity in "cats-and-dogs" is increasing, and this is further verified by last week's American Exchange volume, highest upside volume since late 1961.

SIGNIFICANT CHANGES: Comments in the last Letter regarding the sharp drop in debit balances (or the total amount of margin outstanding on the N.Y.S.E.) have brought requests for more information on this study. I am indebted for much of the original work in this field to my friend Dr. Sloan Wilson of Kansas City.

Within the market there are two large groups whose actions are always worth watching. The first group is composed of the professional speculators. They are the trend-setters, and it is their money that "talks" first. The professional speculator's most important "tool" is his margin account, and from this it follows that a rise or a decline in total margin balances (debits) on the N.Y.S.E. will tell us whether the professional is accumulating (rising debit balances) or distributing (declining debits).

The second important group is made up of the cash customers, and this group (which does not care for margin) can be considered synonymous with the public. The public shows us what it is doing via the credit balances or cash balances in brokerage accounts. When credit balances on the N.Y.S.E. are rising, the cash customer is selling stocks and accumulating cash, and the converse is true when credit balances are falling.



Dr. Wilson's studies of many decades of market action show that the professional is very quick to "get with" the main trend. Thus at the beginning of a bull market, debits are apt to be extremely low. Then, throughout the length of the bull market, debits continue to climb — until a final debit peak is recorded. In 1929 and 1937 the margin accounts actually "topped" simultaneously with the Averages. In other words, the professional tends to assume larger and larger stock holdings during a major rise. But this point is important to remember: from the moment the professional starts cutting back on his holdings (declining debits), the market rise is considered to be on borrowed time. It is then up to the cash customer (the public) to "carry the ball".

The cash customer traditionally acts very differently from the professional. Normally, the cash customer will sell stocks (rising credit balances) during the most important and profitable part of a bull market rise. Then, during the distributive stage the public tends to buy stocks and the credit balances decline. A steady decline in credit balances (as the Averages rise) spells the beginning of the end.

The accompanying chart traces the debits, the credits, the advance-decline ratio and the Industrial Average since 1960. Note that during the 1960-61 period marked "A" on the chart the Dow and the A-D ratio rose sharply. The professional was buying and

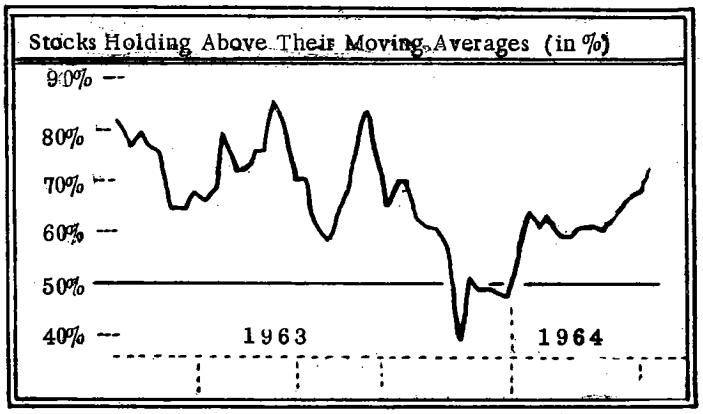
the public was selling. Then in early 1961 ("B" on chart) the public started buying (declining credit balances), and although the Dow continued higher, the A-D ratio "topped out". In other words, the majority of issues topped at about the time the public turned bullish. Finally, in December, the debits turned down exactly with the Industrial Average. This preceded the 1962 market crash.

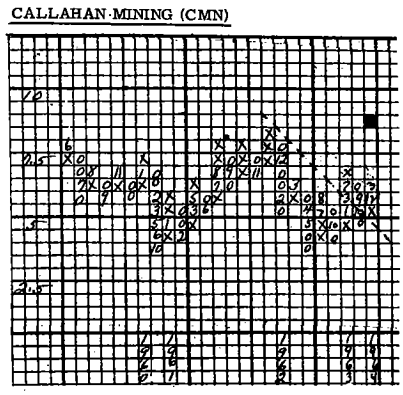
Dr. Wilson has studied a good many of the post-crash periods, and he has noted that the advent of a market crash seems to upset or shock the public so severely that it acts differently during the next market rise. Dr. Wilson has labeled this the "post-crash syndrome", and we see it clearly during the period from October, 1962, to the present.

The public simply has not acted on the current rise the way they did during the 1960-61 rise (and during most other rises). Instead of building up cash in their accounts, the public seems to have acted indecisively during the entire 1962-64 advance, and we see this in the strange sideways movement of the credit balances ("E" on chart). It is possible that this stubborn refusal to do anything one way or the other has accounted for the sideways movement of the majority of stocks on the N.Y.S.E. as measured by the A-D ratio during the period of June, 1963, to the present ("F" on chart). Note that it has been the high-grade stocks, as represented by the Industrial Average, which have made the real progress during the margin build-up ("D" on chart). Thus, we see that the professionals have tended to buy mainly "blue-chips" during 1963-64, while leaving the majority of issues alone.

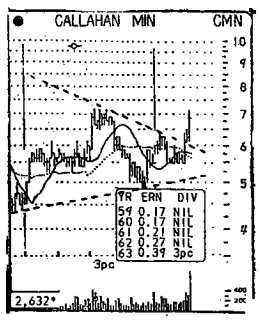
The current picture, as shown on the chart, is this: the professionals have loaded up with stocks (highest debit balances in history), and they have undoubtedly been waiting for the cash public to come in and buy. But the very latest statistics (February, 1964) show what could be a new and dangerous trend. At "G" we see the largest drop in margin accounts since June, 1962 — a drop of $141 Million. At the same time we see a significant decline in the credit balances. It is probable that November, 1963, represented the peak in the debit balances and the beginning of the professionals' exit from the market. On January 3, 1901, Charles Dow wrote: "In most bull markets there comes a time when the public controls the fluctuations, and the efforts of the largest operators are insufficient to check the rising tide." The falling debit balances suggest that it is now up to the public to do the buying. The period directly ahead should tell us whether the public is going to live up to the expectations of the professionals or whether the professionals are going to be fooled by a public which refuses to take the bait (as they did for instance, in 1930 and 1938).

STOCKS: Of 432 stocks which are tabulated here weekly, 305 (71%) are now above their 30-week or long-term moving average (a rise of 3% from last week). This study remains bullish as long as more than 50% of the stocks remain above their moving averages (see chart).





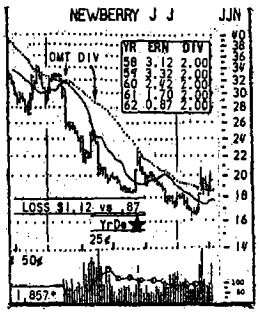
As to speculating in this market, I have drawn attention in recent Letters to the lower-priced cyclical issues. The potentialities in high-grade stocks are now extremely limited, and in many cases the low or non-existant yields represent a powerful inhibiting force against further advance. For this reason, I would prefer keeping the largest amount of funds in cash or the equivalent, and where readers are willing to speculate, I would attempt to obtain leverage from carefully chosen low-priced issues.

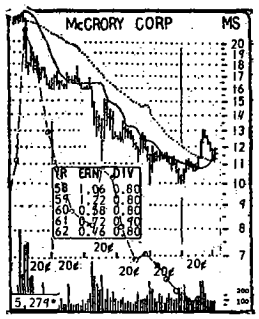


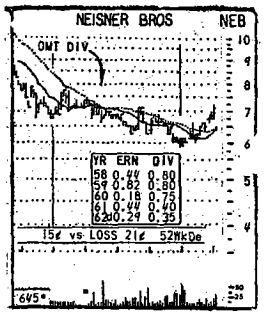
Callahan Mining (Letter 248, recommended at 6 1/4) continues to look like a good "play", even though it has advanced to the area of its last peak. The small weekly chart shows CMN pushing into the 7-7 1/4 area on good volume. The point-and-figure chart illustrates the huge base in CMN and the fact that CMN has reversed a long declining trendline. If CMN can touch 9 (solid black square on P & F chart) it will have given another (and most important) "buy" signal. Should that occur, I suggest that subscribers double up on their original holdings. This is one issue in which I am fairly familiar with the (improving) fundamentals. Earnings for this year should be around 40-45¢ per share, but this includes non-recurring expenses. Rising metal prices (lead, silver, zinc) will undoubtedly boost CMN's current earnings, and the stock could earn in the 55-65¢ range next year.

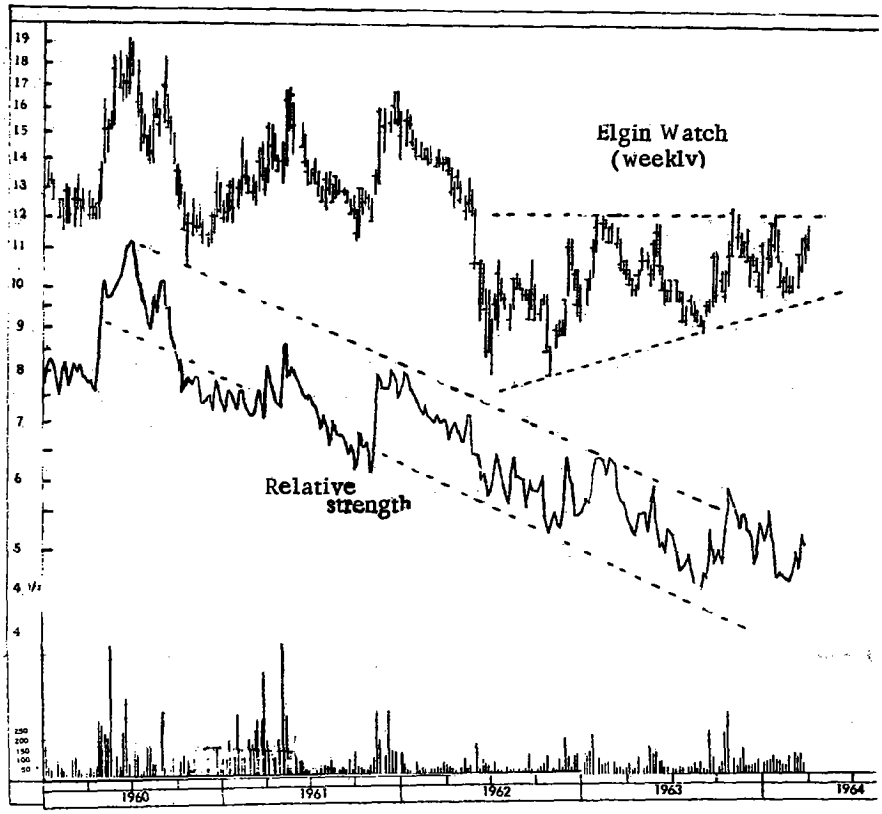
Although Retail Mail Order stores are (as a group) now at the highest relative strength or popularity level in their history, Retail Variety Chains are at their lowest level of R.S. since the 1920's. This Group recorded a peak in popularity in 1934, performed about as well as the market during the '40's, then completely collapsed in R.S. during the 1950's and '60's. They are now as unpopular as airlines were a few years ago. It is therefore interesting to see three depressed stocks in this group (charts on page 4)

pushing above both their 10-week (solid black line) and 30-week (dotted line) moving averages. Newberry sold as high as 33 in 1963 and shows an all-time high of 54. McCrory sold as high as 17 3/4 in 1963 with an all-time high of 25. Neisner's 1963 high was 7 3/4, its all-time high was 26. The variety chain stocks are extremely unpopular and undervalued. If there is to be any sort of a surge in retail spending, these three depressed companies should benefit. A "package" of equal amount of each of the three "orphans" could work out well in a good market. Furthermore, they should be fairly resistant to anything but bankruptcy, as their relative strength cannot go much lower. In actual figures, the R. S. of the Variety Chains Group has declined 75% since 1948.









Elgin Watch has been in the process of forming a giant ascending triangle ever since its 1962 collapse. A four-year decline in the trend of relative strength was almost reversed during late 1963, and Elgin's R. S. line has been pushing against the top of the long declining channel ever since. If the stock touches 12 3/4 to 13 it will have broken out of the triangle. Should this occur, it would seem to be one of the most interesting speculations on the Board.

General Bronze was discussed in Letter 232 (October, 1963: price 17). As seen on the smaller weekly chart, GLZ has pushed out of a long triangle on good volume. This triangle is part of a much larger triangle which has formed over the past two years, and this can be seen on the point & figure chart. The first solid black square represents the initial "buy" signal 16 1/2, and the second black square shows the latest buy signal at 18 1/2. The stock has reversed a five-year declining trend in relative strength (R. S.), and I believe it is still an interesting speculation.

Mesabi Trust (see Letter 228) has pushed out of a large ascending triangle. This stock (which derives all its income from royalties) has important tax features. and enjoys a full write-up in the April 6 issue of Barron's. I believe it is one of the most attractive low-priced issues.

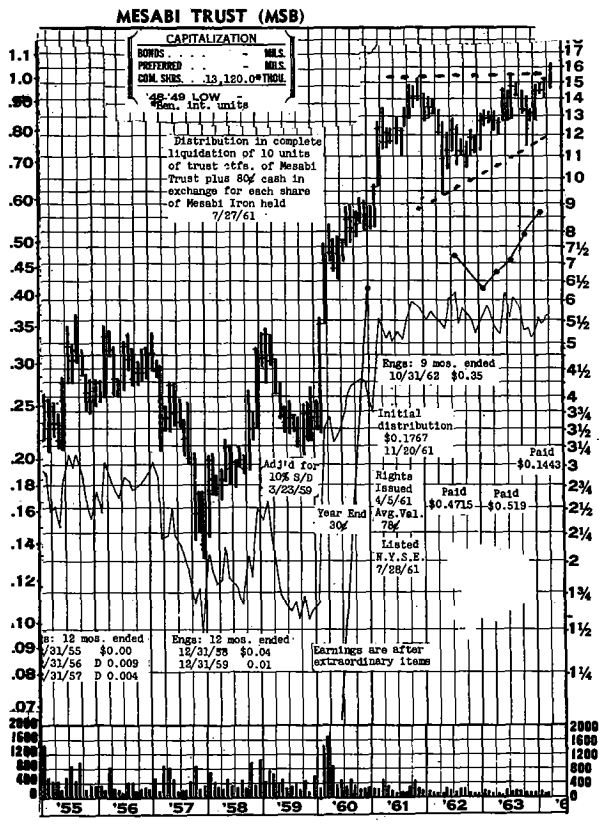


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Chart 1 and chart of Elgin courtesy of Traders Research, 1431 Pearl Ave., Alton, Illinois 62003. Charts of CMN and Variety Chains courtesy of Quote Digest, 110 North Lorraine, Wichita, Kansas. Point & Figure charts courtesy of Chartcraft, Larchmont, New York. Chart of Mesabi courtesy of Securities Research, 211 Congress St., Boston, Massachusetts.